Sales Tax Base Expansion: How to Keep States Focused on Correctly Expanding the Base

Colorado Task Force Concerning Tax Policy
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COST
Council On State Taxation

Agenda

- **The Principles of a Good Consumption Tax**
- **How Much Do Businesses Pay?**
- **Pressures Building for Sales Tax Base Expansion to Services**
- **Expanding the Sales Tax Base Would Be Less Onerous if the States Had More Uniformity**
- **The Major Impediment to Sales Tax Modernization: Sales Taxation of Business Inputs**
- **The Difficulty with Sweeping Sales Tax Base Broadening Legislation Without Exempting Business Inputs**
- **The Poor Performance of Many States on the COST Sales Tax Scorecard**
- **Improving Sales Tax Fairness and Efficiency**

THE PRINCIPLES OF A GOOD CONSUMPTION TAX

The Principles of a Good Consumption Tax

- Primarily applies to final household consumption / exempts business inputs
- Uniform (harmonized) tax base
- Fair and efficient sales tax administration
- Centralized tax administration w/limited local jurisdictions

HOW MUCH DO BUSINESSES PAY?

FY 2021 State and Local Business Tax Burden Study

State and Local Business Taxes by Type, FY21

Colorado and Local Business Taxes by Type, FY21

Source: Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2021, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (Release TBD)

How Much Do Businesses Pay?

- Businesses paid more than $951 Billion in U.S. state and local taxes in FY21, an increase of 13% from FY20
  - 17.6 Billion in Colorado state and local taxes in FY 21, an increase of 13.6% from FY 20 (15.5 Billion)
- State business taxes increased by 16% and local business taxes grew by 10.6%
- In FY21, business tax revenue accounted for 43.6% of all state and local tax revenue
  - Colorado business tax revenue accounted for 45.2% of all state and local tax revenue
    - 32.2% of state taxes
    - 58.1% of local taxes
- Remarkably, the business share of SALT nationally has been within approximately **1% of 44% since FY03 (43.6% for FY21)**
  - Colorado's business share of SALT is 45.2%

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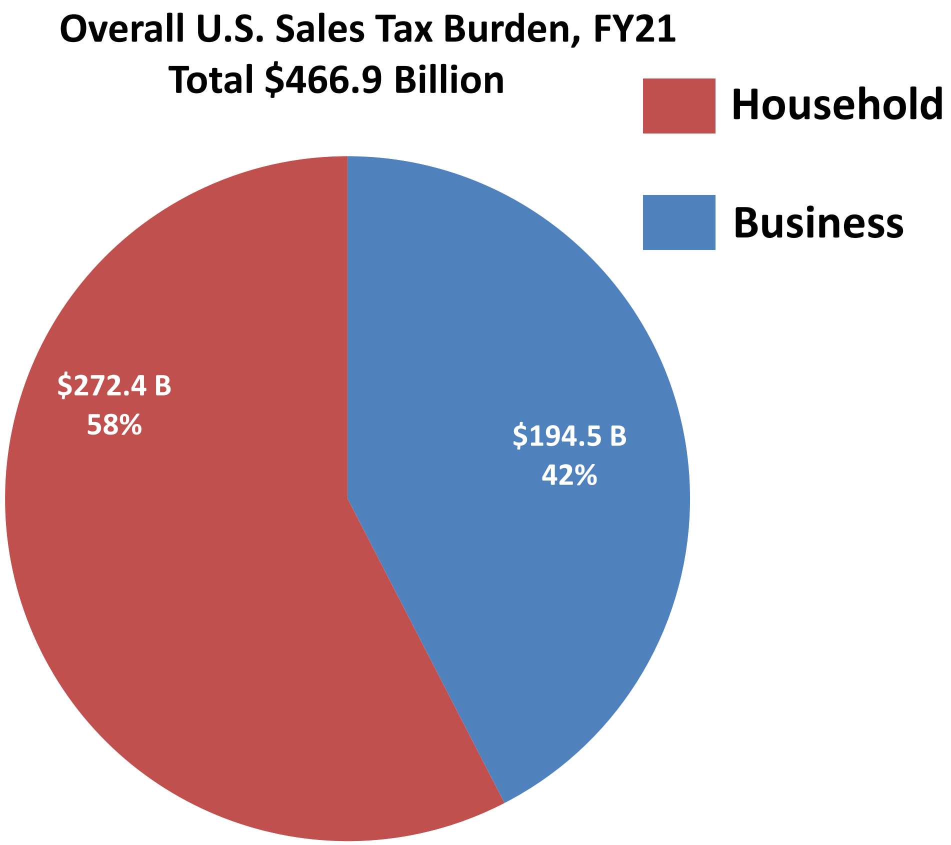
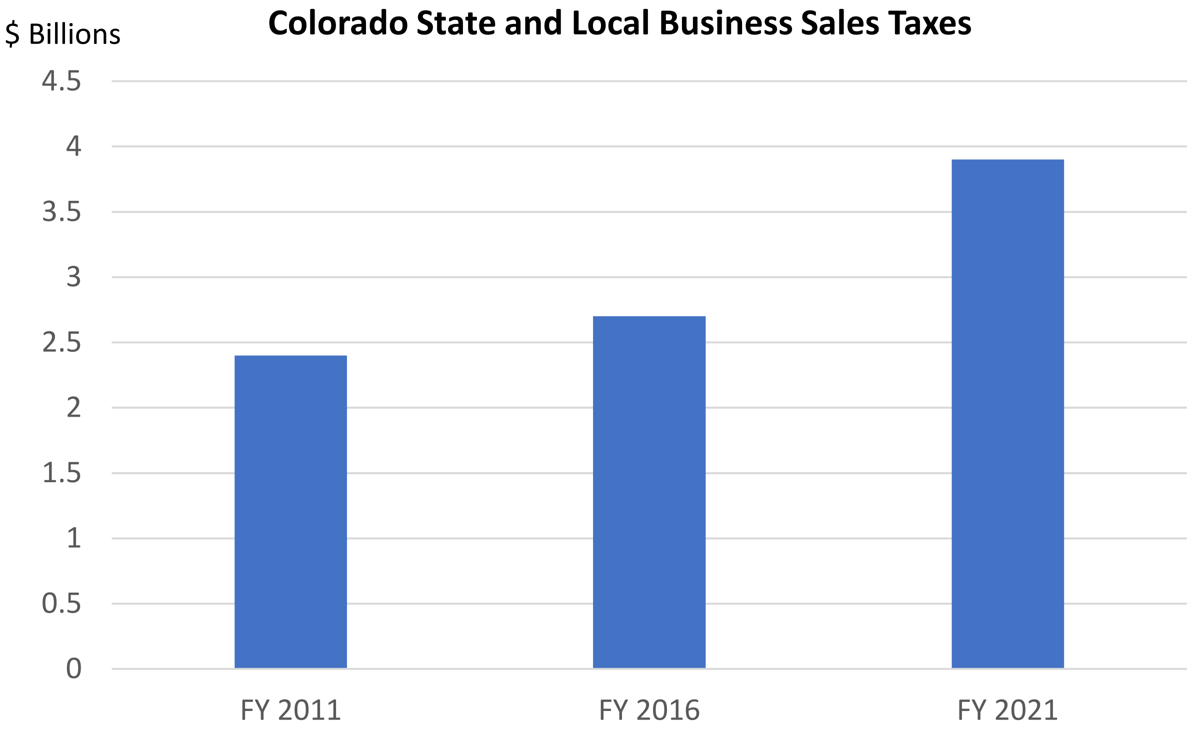
FY 2021 State and Local Business Tax Burden Study

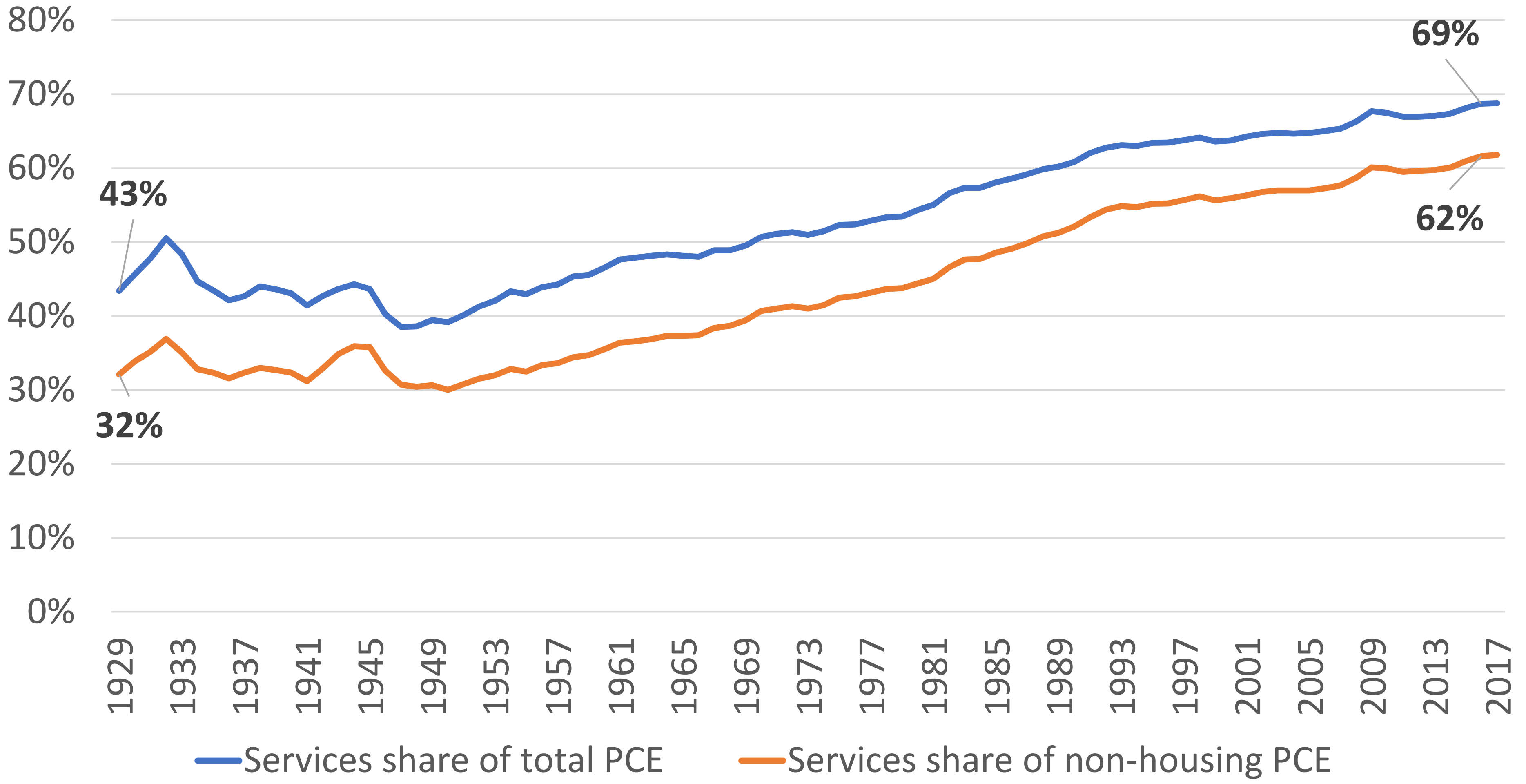




Source: Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2021, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (Release TBD)

PRESSURES BUILDING FOR SALES TAX EXPANSION TO SERVICES

Services As a Share of Total Personal Consumption Expenditures, 1929 – 2017



The Impact of Imposing Sales Taxes on Business Inputs, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (June 2019)

EXPANDING THE SALES TAX BASE WOULD BE LESS ONEROUS IF THE STATES HAD MORE UNIFORMITY

State Remote Seller Collection Versus Efficient and Fair Sales Tax System

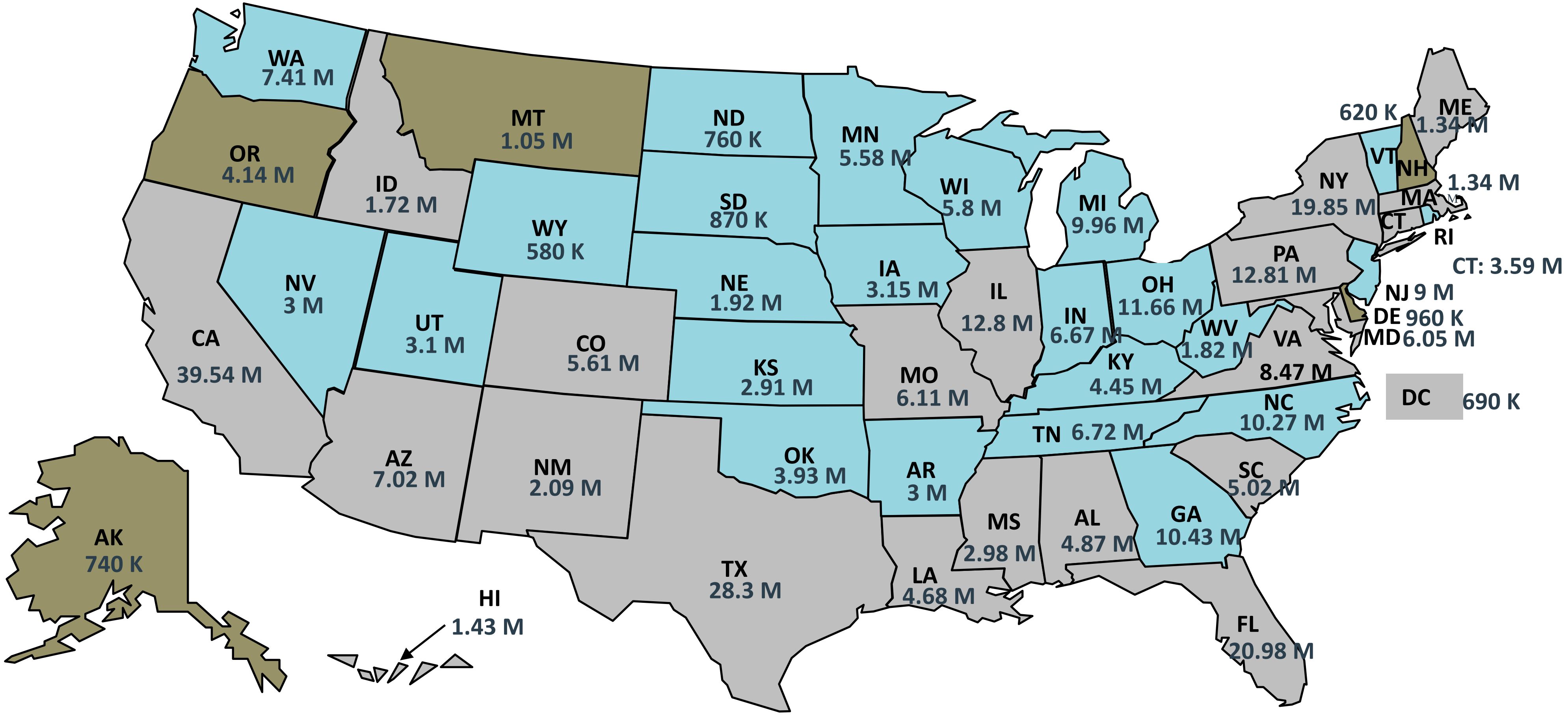
- While the U.S. Supreme Court overturned the longstanding Quill precedent in the Wayfair case, **attaining a level of sales tax simplification and uniformity that satisfies a constitutional "commerce clause" requirement should not be confused with constructing an efficient and fair modern-day sales tax system.**
- Three features the U.S. Supreme Court highlighted with South Dakota's law:
  - No retroactivity
  - Small seller exclusion
  - **State was a member of the Streamlined Sales & Use Tax Agreement (SSUTA)**

Will More States Join the SSUTA?
Streamlined Sales Tax States by Population

Full Member & Associate Member
35.7% of population

Non-Sales Tax States
2.5% of population

Non-SSUTA Sales Tax States
62.3% of population



Source: U.S. Census Bureau

SSUTA Activity – SSUTA “Light”

- The Governing Board recently adopted model language for non-SSUTA States to use to allow them to:
  - Use SSUTA CSP services
    - Still must complete taxability matrix
    - Rate and boundary database
    - Liability relief
  - Use SSUTA Central Registration services
- SSUTA focused on staying relevant and providing guidance to sellers
  - Approach likely to be focused on disclosed practices rather than forcing the SSUTA states to be uniform

THE MAJOR IMPEDIMENT TO SALES TAX MODERNIZATION:

AVOIDING SALES TAXES ON BUSINESS INPUTS

The Problem with Taxing Business Inputs

- This structural flaw of state sales tax systems — the widespread taxation of business purchases (excluding resale) — is of long-standing origin.
- The pyramiding of sales tax at multiple stages of the supply chain creates a number of distortions because it affects business choices of input purchases, location of jobs and investments, and organization of business structures.
- A well-designed broad-based consumption tax on household goods and services can provide an efficient way to raise revenue for government with a minimal impact on economic growth.

However, the cascading of taxes on business inputs can undermine this advantage and penalize both domestic business investment and the competitiveness of U.S. exports.

The Expert's Perspective: Historical Condemnation of the Sales Taxation of Business Inputs

- "In the establishment of the structure of a sales tax, it is highly desirable to confine the tax so far as possible to the sale of consumption goods, since the taxation of producers' goods is not only contrary to the intent and philosophy of the tax, but gives rise to undesirable effects, especially in countries in which maintenance of a high level of investment is important." John F. Due, Sales Taxation (1957)
- "A sensible sales tax would… exempt all sales to business." Charles E. McLure, Hoover Institution, Stanford University, "Understanding the Nuttiness of State Tax Policy," National Tax Journal (September 2005).
- An ideal retail sales tax "…should apply only to consumption expenditures, and thus not to savings or to purchases for use in production." John L. Mikesell, "Reversing 85 Years of Bad State Retail Sales Tax Policy," State Tax Notes, (Feb. 4, 2019).

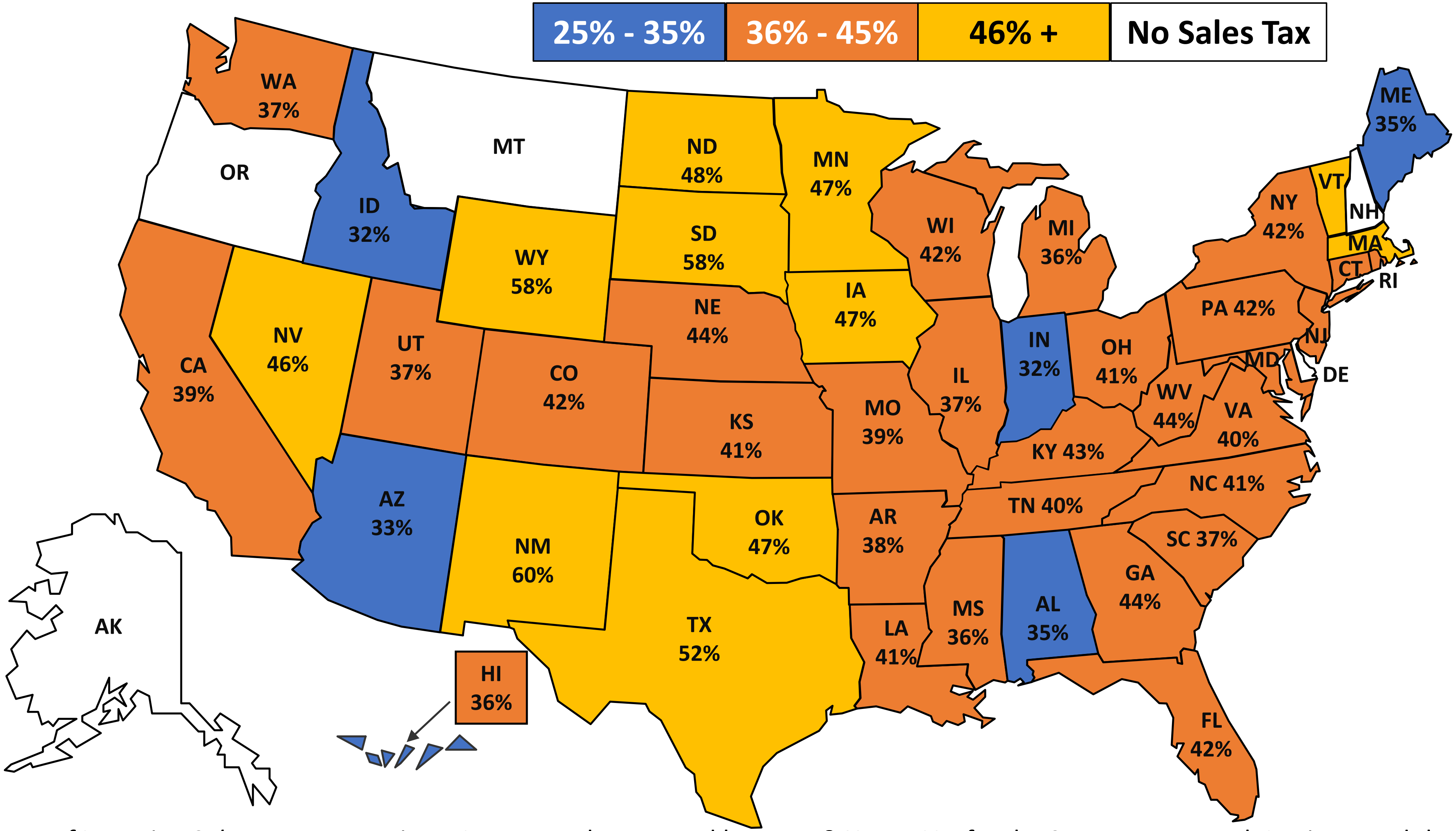
Report on Imposing Sales Taxes on Business Inputs

- **"The Impact of Imposing Sales Taxes on Business Inputs,"** EY, STRI/COST report issued May 2019
- Despite a complex system of exemptions intended to exclude specific categories of business input purchases from the sales tax base, most state sales tax systems fall short of the goal of taxing only household consumption because they impose significant taxes on business-to-business transactions.
- ***State sales taxation of business purchases accounted for 42% of total state and local sales taxes in 2020***

Source: Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2021, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (Release TBD)

State and Local Sales Taxes Imposed on Business Inputs

Business Inputs Share of Total Sales Tax Collected



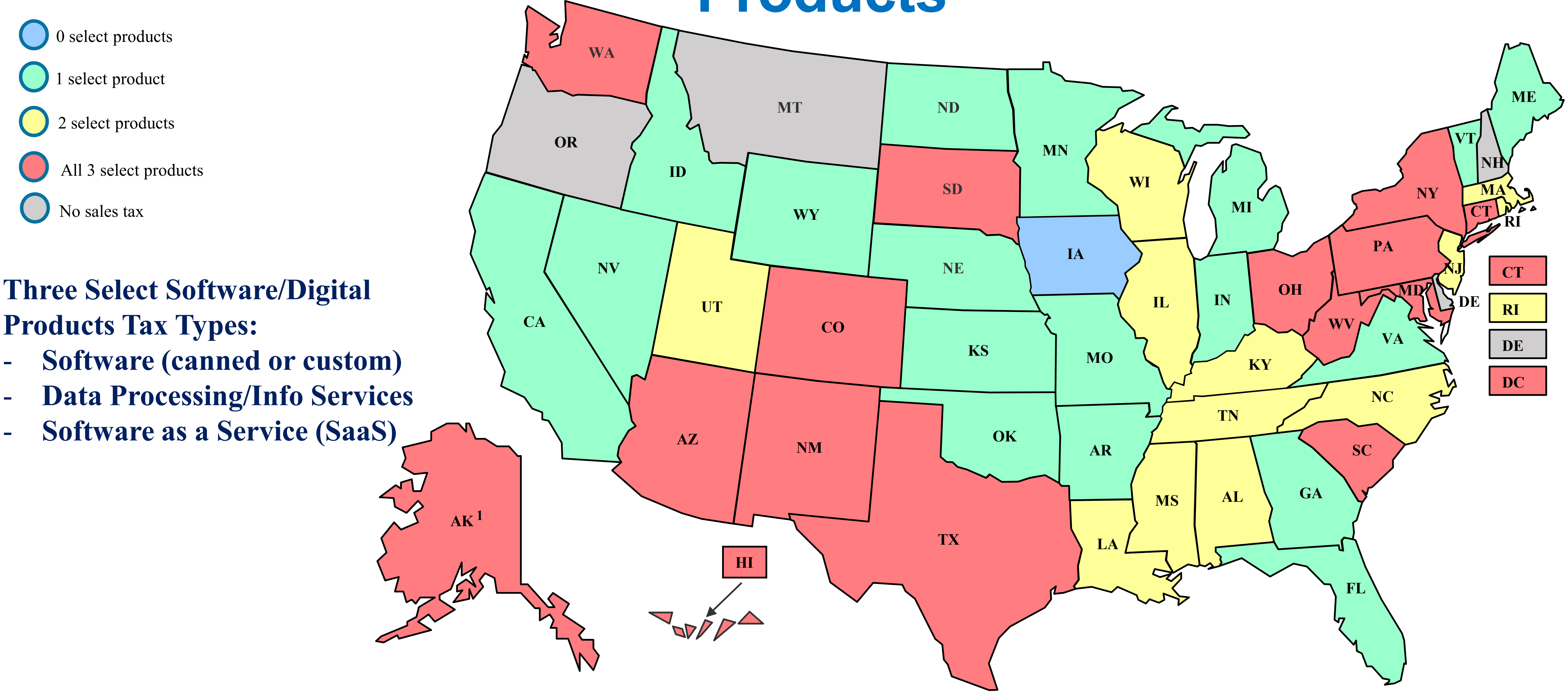
VT = 51%
MA = 48%
CT = 39%
RI = 36%
NJ = 43%
DC = 42%
MD = 42%

The Impact of Imposing Sales Taxes on Business Inputs, study prepared by Ernst & Young LLP for the State Tax Research Institute and the Council On State Taxation (May 2019)

The Sales Taxation of Digital Commerce

- Over the last quarter century, the sales taxation of digital commerce has emerged as one of the most prominent and contentious issues in state taxation
- **Four significant issues have dominated the public dialogue:**
  - Whether states have jurisdictional nexus over remote sellers
  - Which digital goods and services should be included in (or excluded from) the sales tax base
  - How to define and categorize digital products for sales tax purposes
  - How to source sales of digital products
- One central problem, however, regarding the sales taxation of digital commerce has been generally ignored or underreported – **the extent to which the sales tax base includes not only business-to-consumer (B2C) transactions but also business-to-business (B2B) transactions**

Tax on Business Purchases of Select Software and Digital Products



Three Select Software/Digital Products Tax Types:

- Software (canned or custom)
- Data Processing/Info Services
- Software as a Service (SaaS)

Disclaimer: *This information should be used for general guidance and not relied upon for compliance.*

Source: *Council On State Taxation (COST)*

[1] Data is based on local municipalities since Alaska does not have a state-wide sales tax

[2] Data is includes local jurisdictions even if the state's base may not include some of these products

Broad Exemption: Iowa's Exemption for Business Purchases of Software and Digital Products

- **Iowa** provides the broadest exemption for business purchases of digital commerce.
- Iowa provides a statutory exemption that covers specified digital products, prewritten computer software, and some enumerated services furnished to a commercial enterprise for use exclusively by the enterprise.
    - Included in the "enumerated services" are information services, custom software, and SaaS.
- "Commercial enterprise" is broadly defined to include: (1) businesses and manufacturers operating for profit; (2) insurance companies (for-profit and nonprofit); (3) financial institutions (for-profit and nonprofit); (4) professions and occupations; and (5) public utilities.
- As summarized by the Iowa Department of Revenue in a guidance document, specified digital products, prewritten computer software, information services, and SaaS are exempt "when purchased by a commercial enterprise and used exclusively by or furnished to that commercial enterprise."
    - Furthermore, to qualify for "use exclusively by the commercial enterprise," the use for noncommercial purposes must not be more than de minimis.

Manufacturing and Resale Exemptions for Business Inputs

- **Resale exemptions** for business inputs are tailored towards buying and selling TPP and need modified to address digital products that are not resold in exactly the same form – e.g., two products merged together
- **Services** – exemptions for inputs (equipment) are often not considered
- **Manufacturing exemptions** can have limited application the production of digital products, often dependent on the classification of the digital product as TPP
- Consideration of exemptions to the sale of tangible personal property versus digital products
  - Purchase physical item that is digitized, e.g., a poster – exemptions should include content, materials, equipment, consumables, software, packaging equipment
  - Purchase of two different digital products and resold as merged product – resulting merged product for sale could be subject to tax, but seller's purchase of the two products should be exempt (resale and/or manufacturing)

THE DIFFICULTY WITH SWEEPING SALES TAX BASE BROADENING LEGISLATION WITHOUT EXEMPTING BUSINESS INPUTS

Examples of Recently Enacted Sales Tax Base Expansion

- Over the last three decades, states have repeatedly sought to extend the sales tax base to cover a wide range of services.
  - Bolstered by the issue of remote seller collection being settled by *Wayfair*
- **North Carolina** (2017) with an emphasis on taxing services delivered by sellers with an existing sales tax obligations.
- **Kentucky** (2022) added to the sales and use tax on many services with goal to reduce the State's personal income tax rate.
- **Many states** have expanded the sales tax base to include newly digitized goods and services that were previously taxed as tangible personal property (movies, books, audio, etc.).

Utah – Case Study in Sales Tax Base Expansion Complexity

- In January, 2019, Utah Gov. Herbert (R) proposed sales tax base broadening while lowering the sales tax rate from 4.85 percent to 1.75 percent (H.B. 441 had limited exemption of B2B services).
  - COST concerned with lack of comprehensive B2B exemption
- In December 2019, Utah enacted legislation that expanded the sales tax base on some services, motor fuels, and subjected groceries to the full sales tax rate.
- Citizens reacted with over 150,000 signatures to repeal the tax package
- On January 29,Utah Legislature enacts HB 185, repealing SB 2001

Failed Attempts at Sweeping Sales Tax Base Broadening Legislation

- The state and local political landscape is littered with examples of states that failed to enact (or sustain) major sales tax base expansion even with significant gubernatorial or legislative support.
  - Florida (1987)
  - Massachusetts (1991)
  - Michigan (2007)
  - Nebraska (2013)
  - Ohio (2013)
  - Louisiana (2013)
  - Minnesota (2013)
  - Pennsylvania (2015)
  - Maine (2015)
  - Utah (2019)
  - Connecticut (2019)
  - South Carolina (2019)
  - Maryland (2020)
  - Nebraska (2020)

The Difficulty with Sweeping Sales Tax Base Broadening Legislation

- Several factors are responsible for the failure of wide-scale sales tax base expansion, including the difficulty of enacting large-scale tax reform, the objection of impacted service providers, and general public resistance to new taxes.
- *But certainly, the most important common factor has been the principled opposition from the business community*. Generally, the policy objections were not to the expansion and modernization of the sales tax base to include the growing services sector, but to doing so without limiting the base expansion to household purchases and exempting business inputs.

The "Catch 22" of Sales Tax Base Expansion

- By now, the historic lesson should be clear: the extension of the sales tax base to include business services is inconsistent with creating a more efficient and modern sales tax system.
- States that include business purchases in sales tax base expansion not only diverge from theoretical norms of an ideal sales tax system, but also risk near-certain defeat of comprehensive base-expansion legislation.
- **States should recognize that if their goal is to modernize and broaden the sales tax base, expansion to include more services purchased by households, but not businesses, is better than no reform at all.**
- An improved understanding of the extent and negative impact of sales taxes imposed on business inputs will enhance the potential for future sales tax reform to better comply with the principles of taxing final consumption of household goods and services while exempting intermediate business inputs.

COST filed comments noting violations of tax policy principles of economic growth, equality, simplicity, and efficiency. Imposing the tax on business-to-business services would result in pyramiding of the tax from it being imposed at multiple levels, instead of the end-user consumer.

Share of Services Purchased by Businesses and Personal Consumption, 2016

Industry	Business share	Personal consumption share
Administrative and support services	93%	7%
Broadcasting and telecommunications	50%	50%
Computer systems design and related services	100%	0%
Data processing, internet publishing, and other information services	77%	23%
Federal Reserve banks, credit intermediation, and related activities	67%	33%
Food services and drinking places	23%	77%
Insurance carriers and related activities	67%	33%
Legal services	68%	32%
Management of companies and enterprises	100%	0%
Publishing industries, except internet (includes software)	37%	63%
Rental and leasing services and lessors of intangible assets	73%	27%
Securities, commodity contracts, and investments	54%	46%
Waste management and remediation services	78%	22%

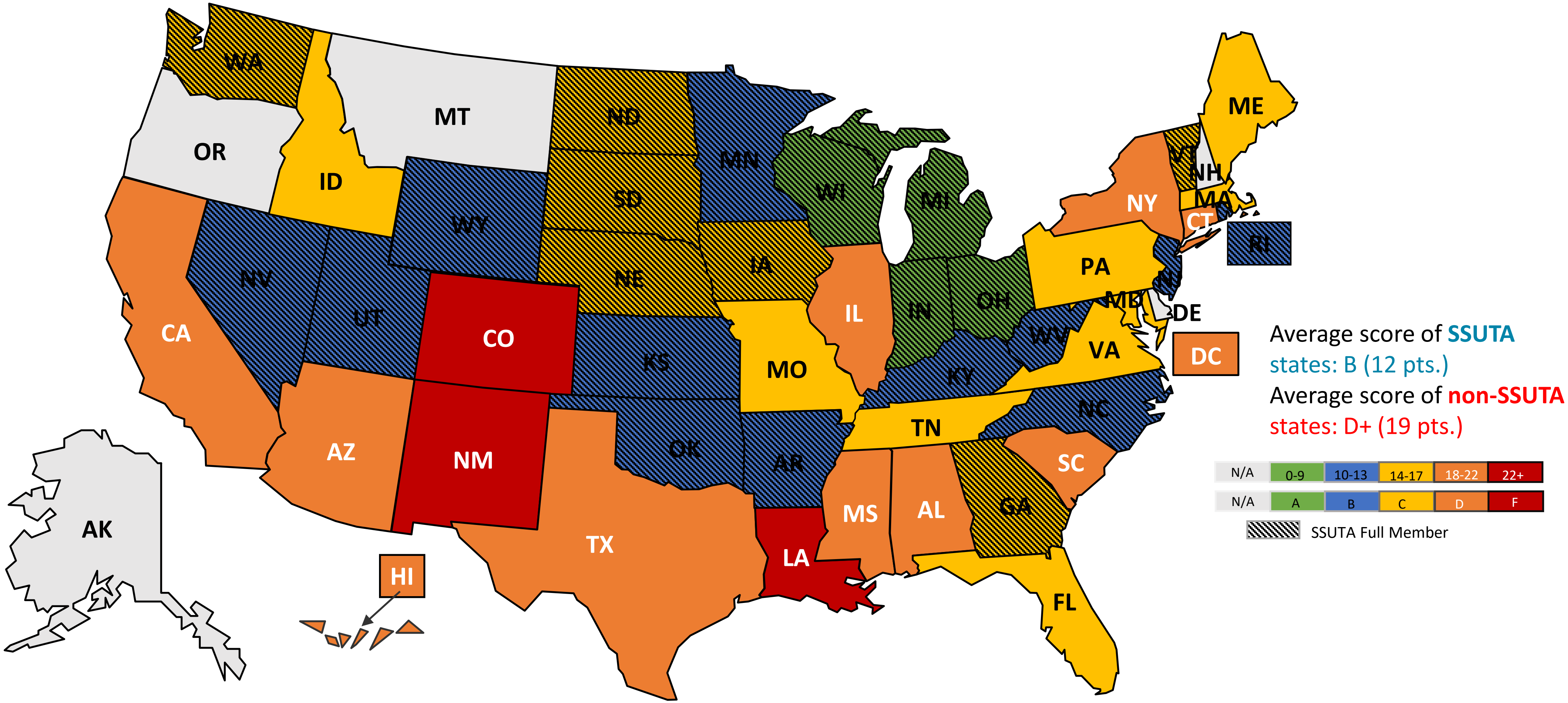
Bureau of Economic Analysis, 2016

THE POOR PERFORMANCE OF MANY STATES ON THE SALES TAX SCORECARD

State Sales Tax Systems: COST'S Categories for Grading States

- **The Best & Worst of State Sales Tax Systems: COST Scorecard on Sales Tax Simplification, Uniformity and the Exemption of Business Inputs**
  - First Edition released April 2018; Revised Edition forthcoming November 2022
- **2018 Scorecard Categories**
  - Exemption for Business-to-Business Transactions
  - Fair Sales Tax Administration
  - Centralized Sales Tax Administration
  - Simplification & Transparency
  - Reasonable Tax Payment Administration
  - Fair Audit/Refund Procedures
  - Other Issues Impacting Fair Tax Administration
- **What the Scorecard Does <u>Not</u> Grade**
  - Tax Rate Differences
  - Tax Base Breadth (other than Taxing Business Inputs)

Overall Scorecard Grades: SSUTA vs. Non-SSUTA States



Average score of **SSUTA** states: B (12 pts.)

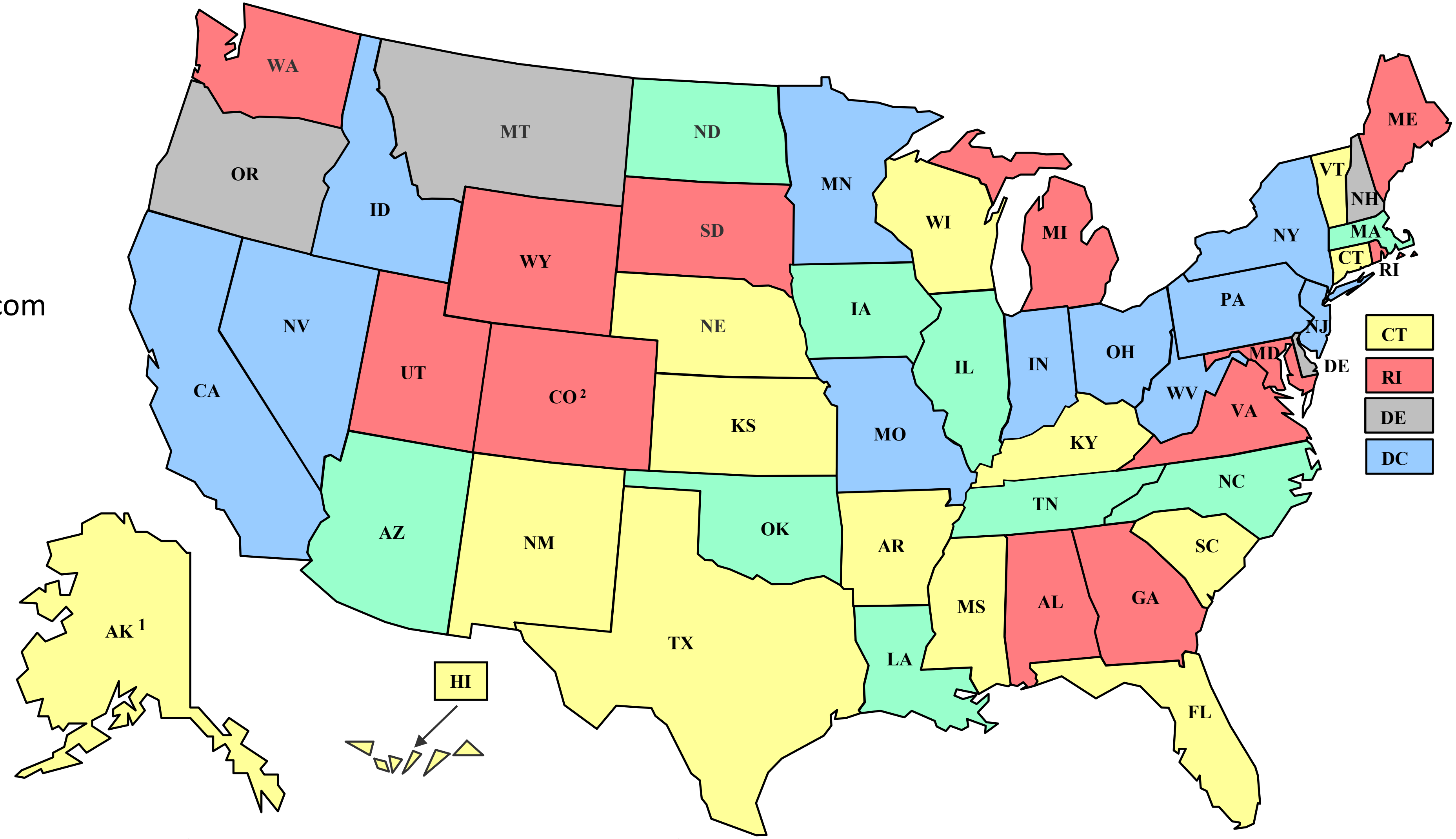
Average score of **non-SSUTA** states: D+ (19 pts.)

No double taxing
Double taxes one utility
Double taxes 2 utilities
Double taxes 3 utilities
No sales tax

Sales Taxation of Business Inputs Results in Extensive Pyramiding of Tax: Double Taxation of Select Service Providers (Telecommunications, Cable, and Electric and Natural Gas Utilities)

<u>Select Utility Ind.</u>

- Wired and Wireless Telecom
- Cable
- Electric and Gas



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IMPROVING SALES TAX FAIRNESS AND EFFICIENCY

Colorado Specific Problems with Sales Tax Administration

- Lack of full central administration of the State's sales tax system
  - Home rule locals can use different definitions and have different bases
  - Tax filings and exemptions must be made to multiple locations
  - Interpretations of taxability can differ – e.g., shipping charges
- TABOR – any expansion of the tax base can impact TABOR requirements
- Additional "undue burdens" could put remote sales tax collection in jeopardy as mentioned in *Wayfair* decision
- Iowa's "commercial enterprise" exemption should be used as a model and expanded to apply to all business-to-business services – however, it puts pressure on what activities constitute "business activity" to be exempt
- Impact of recent tax legislation, *e.g.*, retail delivery fee

Other Problems with Sales Tax Administration

- Legislation needed to not allow:
  - False claim or class actions suits to all taxes, including transactional taxes
  - Tax administration should solely be handled by a state’s revenue agency
- Alabama, Colorado, and Louisiana need to follow Arizona's footsteps and eliminate local administration of their sales/use taxes
- States need to review current laws hastily enacted to address marketplace facilitators and thresholds to enhance uniformity with other states

Relevant COST Articles

- **Down the Rabbit Hole: Sales Taxation of Digital Business Inputs**, by Karl A. Frieden, Fredrick J. Nicely, and Priya D. Nair, July 2022
- **Resisting the Siren Song of Gross Receipts Taxes: From the Middle Ages to Maryland's Tax on Digital Advertising**, by Richard Pomp/STRI, July 2022
- **Locally Administered Sales and Accommodations Taxes: Do They Comport with *Wayfair?***, by Harley Duncan and Sarah McGahan, KPMG, July 2022
- **A Global Perspective on U.S. State Sales Tax Systems as a Revenue Source: Inefficient, Ineffective, and Obsolete**, by Karl Frieden and Douglas Lindholm, November 2021
- **Total State and Local Business Taxes for Fiscal Year 2020**, COST/STRI/EY, October 2021
- **The Impact Of Imposing Sales Taxes On Business Inputs**, COST/STRI/EY, May 2019
- **What's Wrong with Taxing Business Services?**, COST/EY, April 2013
- **Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services**, COST, January 2005

**All found at COST Studies, Articles And Reports:* https://www.cost.org/state-tax-resources/cost-studies-articles-and-reports/

QUESTIONS

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